Before The
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers	)	WC Docket No. 03-173

Reply Declaration of

Richard B. Lee

On Behalf of

AT&T Corp.

January 30, 2004

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I. INTRODUCTION AND QUALIFICATIONS

1. My name is Richard B. Lee. I am Vice President of the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business address is 1220 L Street, N.W., Suite 410, Washington, D.C. 20005.

2. I submitted a Declaration in this proceeding on December 16, 2003, which contained a description of my background and experience.

3. The purpose of this Reply Declaration is to respond to Verizon Telephone Companies' ("Verizon") witness John M. Lacey on the subject of the depreciation lives appropriate for use in Total Element Long-Run Incremental Cost ("TELRIC") studies for the development of Unbundled Network Element ("UNE") prices and to respond to similar statements and analyses provided by BellSouth.

4. In Section II of this declaration, I respond to Dr. Lacey's contention that financial book lives should be used in calculating UNE rates. I explain that such lives are too conservative, i.e.-short, for use in regulatory proceedings.

5. In Section III, I explain why the lives forecasted by Technology Futures, Inc. ("TFI") do not provide an appropriate benchmark for evaluating the lives to be used in UNE proceedings.

6. In Section IV, I explain why BellSouth's portrayal of switching technology lives is wrong. In Section V, I explain why other company lives do not provide an appropriate benchmark for evaluating the lives to be used in UNE proceedings.

Finally, in Section VI, I explain why Dr. Lacey's criticisms of the FCC's regulatory lives are baseless.

II. FINANCIAL BOOK LIVES REMAIN INAPPROPRIATE FOR TELRIC CALCULATIONS

7. Dr. Lacey contends that financial book lives, determined in accordance with Generally Accepted Accounting Principles ("GAAP") should be used in developing UNE rates.[1] In my declaration I explained at length why financial book lives remain inappropriate for TELRIC calculations.[2]

8. Financial book lives are significantly shorter than the lives prescribed by the Federal Communications Commission ("FCC"), and are an unsuitable proxy for economic lives. Financial book lives are too short because they are driven by the GAAP principle of conservatism, which encourages the accountant to err on the side of overstating costs for financial reporting when there is uncertainty about their precise level.

9. The FCC has repeatedly rejected the argument that GAAP lives should be used for regulatory purposes. For example, the FCC rejected the use of GAAP asset lives in 1993, because it would allow the ILECs to overstate its costs (and thus understate earnings):

> One of the primary purposes of GAAP is to ensure that a company does not present a misleading picture of its financial condition and operating results by, for example,

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[1] Lacey Declaration, at 8.

[2] Lee Declaration, at 35-41.

> overstating its asset values or overstating its earnings, which would mislead current and potential investors. GAAP is guided by the conservatism principle which holds, for example, that, when alternative expense amounts are acceptable, the alternative having the least favorable effect on net income should be used. Although conservatism is effective in protecting the interest of investors, it may not always serve the interest of ratepayers. Conservatism could be used under GAAP, for example, to justify additional (but, perhaps not "reasonable") depreciation expense by a LEC to avoid its sharing obligation. Thus, GAAP would not effectively limit the opportunity for LECs to manage earnings so as to avoid the sharing zone as the basic factor range option. In this instance, GAAP does not offer adequate protection for ratepayers.[3]

10. This is also why the FCC expressly rejected the use of financial book lives for its cost model in its *Universal Service* proceeding in 1999:

> We also agree with GSA's comments that the projected-life values currently used by LECs for financial reporting purposes are inappropriate for use in the model. In addition, the commenters proposing these values have not explained why the values used for financial reporting purposes would also reflect economic depreciation. The depreciation values used in the LECs' financial reporting are intended to protect investors by erring on the side of conservative understatement of net assets, partially achieving this goal by erring on the side of over-depreciation. These preferences are not compatible with the accurate estimation of the cost of providing services that are supported by the federal high-cost mechanism. We, therefore, decline to adopt the proposed life values used by LECs for financial reporting purposes.[4]

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[3] *Simplification of the Depreciation Prescription Process, CC Docket No. 92-296 ("Prescription Simplification"), Report and Order*, FCC 93-452, released October 20, 1993, at 46.

[4] Federal-State Joint Board on Universal Service and Forward-Looking Mechanism for High Cost Support for Non-Rural LECs, Tenth Report and Order, 14 FCC Rcd. 20156 (1999), at 429; accord, 1998 Biennial Regulatory Review—Review of Depreciation Requirements for Incumbent Local Exchange Carriers, CC Docket No. 98-137 (rel. Dec.

11. Dr. Lacey argues that GAAP has essentially rescinded the principle of conservatism.[5] He is simply repeating an argument that he has made – and seen rejected – many times before. Specifically, he implies that the Accounting Standards Executive Committee eliminated the principle of conservatism in 1993 when it repealed "Accounting Principles Board Statement 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" ("APB Statement 4"). However, APB Concepts Statements No. 2 ¶ 91 *et seq.* ("Conservatism") was *not* repealed. Because the Concepts Statements stand on their own, superseding APB Statement No. 4 has *no impact on financial reporting*. APB Concepts Statements No. 2 ¶ 91 *et seq.* ("Conservatism") provide a detailed exposition of the currently operative principle of conservatism. Of particular relevance is the following portion of ¶ 95:

> Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. *Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate*; however, if two amounts are not equally likely, conservatism does not necessarily dictate using the more pessimistic amount rather than the more likely one.[6]

12. In the recent arbitration between AT&T and Verizon Virginia conducted by the Wireline Competition Bureau, Dr. Lacey made the same argument and was

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30, 1999) at 48 ("although conservatism is effective in protecting the interests of investors, it may not always serve the interests of ratepayers").

[5] Lacey Declaration, at 32-34.

[6] APB Concepts Statements No. 2 at 95 (emphasis added).

confronted on cross-examination with these facts. On the stand, he conceded that the Concept Statements represented "current accounting standards."[7] In an attempt to salvage his testimony, however, he offered interpretations of the conservatism principle that would have essentially drained it of all meaning. He maintained, for example, that the conservatism principle is merely a tie-breaker comparable to a "coin flip," used only when we are "completely unsure" and have "no idea" what the correct value is.[8] Indeed, he argued that the conservatism principle should not be applied "*no matter how large* the uncertainty is in relation to the expected value."[9]

13. Dr. Lacey's attempts to define away the conservatism principle are baseless. Nothing in the GAAP pronouncements cited by Dr. Lacey suggests that the accounting profession intended to nullify the conservatism principle in this way. The Wireline Competition Bureau also rejected Verizon's contentions (based on Dr. Lacey's testimony) that financial book lives are an appropriate measure of the economic life of an asset.[10]

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[7] *In the Matter of Petition of WorldCom, Inc., Pursuant to Section 252(e)(5) of the Communications Act for Expedited Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia, Inc., and for Expedited Arbitration*, CC Docket No. 00-218 *et al.*, ("*Virginia Arbitration*"), 11 Tr. 3314 (Oct. 23, 2001).

[8] *Id.* at 3317-18.

[9] *Id.*, at 3322. In his view, a decision would have too much information to invoke conservatism even if the standard deviation from the expected value of a depreciation life was as large as the expected value itself. *Id.* at 3319-20.

[10] *Virginia Arbitration, Memorandum Opinion and Order, DA 02-2738, released August 29, 2003 ("Virginia Arbitration Order")*, at 116.

14. Dr. Lacey's attempts to argue that GAAP is not characterized by conservatism are especially baseless in the context of depreciation, because it is difficult to imagine any accounting item that is more difficult to quantify with precision than the expected economic life of a class of assets. As the Financial Accounting Standards Board has explained:

> Some accounting measurements are more easily verified than others. Alternative measures of cash will be closely clustered together, with a consequently high level of verifiability. There will be less unanimity about receivables (especially their net value), still less about inventories, and *least about depreciable assets, for there will be disagreements about depreciation methods to be used, predictions about asset lives*, and (if book values are based on historical cost) even which expenditures should be included in the investment base. *More than one empirical investigation has concluded that accountants may agree more about estimates of the market values of certain depreciable assets than about their carrying values*. Hence, to the extent that verification depends on consensus, it may not always be those measurement methods widely regarded as "objective" that are most verifiable.[11]

If the GAAP principle of conservatism does not apply to depreciation lives, it applies nowhere.

15. The suggestion that the accounting profession has now abandoned conservatism is all the more baseless considering the numerous high-profile accounting scandals involving Enron and other companies that have occurred in recent years. Indeed, there is no basis for assuming that the opinions of theoreticians like Dr. Lacey on this issue reflect the actual practices of corporate accountants

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[11] FASB, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (May 1980) at 85.

and their outside auditors in the field. The FASB itself has noted that the adherence of accounting practitioners to a highly aggressive form of conservatism is deeply ingrained:

> conservatism has long been identified with the idea that deliberate understatement [of net assets and profits] is a virtue. *That notion became deeply ingrained and is still in evidence despite efforts over the past 40 years to change it.*[12]

16. Dr. Lacey further claims that telephone companies have no incentive to understate depreciation lives because those lives are also used for financial reporting. Although the adoption of longer depreciation lives will increase a company's *reported* earnings in the short run, this accounting change does not increase a company's *long-term* earnings or cash flows by a penny. In contrast, adoption of shorter financial book lives *can* increase a company's *long-term* earnings if regulatory commissions adopt them and thereby acquiesce in higher UNE prices. The carrier would thus gain an increased barrier to competitive entry by CLECs, and therefore an increased ability to maintain supranormal returns.

17. Interestingly, the Regional Bell Operating Companies ("RBOCs") seem to have found a way to have their conservative cake and eat it, too. The RBOCs have

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[12] FASB *Original Pronouncements*, Concepts Statements No. 2 at 93. *See also 1998 Biennial Regulatory Review, supra*, at 48 ("we are not persuaded that the role of the conservatism principle in GAAP has changed").

been supplementing their recent quarterly external reports with "normalized" non-GAAP "reconciliations."[13] These reports adjust accounting entries required by GAAP relating to many matters, including asset impairment charges and depreciation. Qwest states that "adjusted" Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITA") is "a non-GAAP measure representing an important indicator of profitability for capital intensive businesses."[14] Qwest also states that "We also use Adjusted EBITDA internally for a variety of purposes, including setting targets for compensation."[15] For the Nine Months Ended September 30, 2003, the elimination of $2 billion in depreciation helped Qwest report adjusted EBITA income of $2.5 billion instead of a (GAAP-based) EBITA loss of $163 million.[16] It would appear that the RBOCs believe GAAP reports need to be adjusted to be useful. Certainly, financial book lives, based on GAAP, should not be used by regulators in TELRIC calculations.

III. TFI LIVES DO NOT PROVIDE AN APPROPRIATE BENCHMARK

18. Dr. Lacey notes Verizon uses the lives forecast by TFI as a benchmark in determining its financial book lives.[17] TFI lives, however, do not provide an appropriate benchmark for lives to be used in TELRIC calculations.

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[13] See, e.g. Qwest Communications, 3rd Quarter 2003 Non-GAAP Reconciliations (Attachment 1); BellSouth Corporation, Normalized Basis (Attachment 2).

[14] Attachment 1, at 2.

[15] Id.

[16] Id.

[17] Lacey Declaration, at 22. SBC Communications, Inc. ("SBC") references TFI forecasts in its Opening Comments at 52-53. BellSouth not only uses TFI studies as a

19. TFI's recommendations are based on studies sponsored by the Telecommunications Technology Forecasting Group ("TTFG"), an industry association of major incumbent local exchange carriers ("ILECs") in the United States and Canada. TFI's studies have been used frequently by ILECs to support shorter lives in regulatory depreciation proceedings. TFI's President, Lawrence K. Vanston, has testified on behalf of GTE, Rochester Telephone Corporation, Southern New England Telephone, and various RBOCs, including Verizon, in the U.S., and on behalf of Bell Canada and the other Stentor Companies in Canada.

20. Regulators have generally rejected the depreciation lives proposed by Dr. Vanston. For example, Dr. Vanston testified as a witness for Verizon in various state UNE proceedings. Most of these state commissions rejected Dr. Vanston's proposals and adopted the FCC-based lives that I recommend. TFI lives have also been the basis of ILEC proposed lives before the FCC. The FCC has not adopted the TFI lives.

21. TFI develops its life estimates largely through "substitution analysis", which purports to forecast the pattern by which new technology will replace old technology. TFI again predicts here, as it has faithfully in all of its analyses over the last decade, an imminent "avalanche" of retirements in various accounts based upon the application of past retirement patterns of obsolete technologies

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benchmark (Comments, Exhibit 4, at 7-8), it provides an "Economic Life Study" based upon the substitution analysis techniques developed by TFI (Comments, Exhibit 4). The discussion of TFI's studies herein applies equally to BellSouth's study.

to future circumstances. This technique relies, for example, on historical retirement patterns such as those describing the replacement of crossbar switches in the 1980's coupled with an assertion that beginning next year, this pattern of retirements will commence for the affected account.

22. TFI assumes that the ILECs will replace their narrowband telecommunications networks with broadband integrated networks capable of providing both telecommunications services and high-speed data services. According to TFI, Fiber In The Loop ("FITL") will bring broadband to the home, displacing copper plant. This will result in the upgrading of transmission systems, replacing existing circuit equipment. Also, packet switching equipment will provide a broadband switching capability replacing today's digital switches.

23. The substitution analyses TFI performs with respect to these forecasted technology developments are designed to superficially appear quite sophisticated, but the lives generated by them are only as correct as TFI's assumptions. Substitution analysis merely provides a convenient method for plotting by year the growth of new technology, assuming the inputs to one's formula are correct. As the Supreme Court has explained, "[t]he calculations [of depreciation expenses] are mathematical but the predictions underlying them are essentially matters of opinion."[18]

24. But substitution analysis is not even relevant unless it is known that a new technology will replace, not supplement, an older technology. For example, asynchronous transfer mode/internet protocol ("ATM/IP") switches are generally

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[18] Lindheimer v. Michigan Bell Tel. Co., 292 U.S. 151, 169 (1934).

being deployed as a supplemental technology to digital switches, not as a replacement for them. As such, substitution analysis is of no relevance.

25. Indeed, even when a substitution has started, it does not necessarily follow that it will finish according to pattern. It appeared at one point, for example, that nuclear fuel would replace fossil fuel in electrical generation in this country. The use of substitution formulas in that case would have resulted in dramatically incorrect predictions.

26. Even if a full substitution is likely, the formula requires the user to predict both the rate of substitution and the point at which the replacement technology will reach 50 percent of the universe of equipment being studied.[19] In other words, the analyst must insert as an *input* the average remaining life of the *old* technology, since this is essentially the 50 percent level of the *new* technology.

Although the substitution methodology allows the preparation and presentation of impressive looking charts and tables, the elaborate results merely restate in numerical and graphical form the assumptions made by the analyst. The outputs obtained by TFI with this methodology thus are no more credible than TFI's inputs. And every year that has passed since TFI began performing these analyses in the '80s has provided proof that not only are TFI's input assumptions highly inaccurate, but they display a large and persistent bias towards understating expected lives.

27. Furthermore, substitution analysis – even if accurate, which TFI's is not – would

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[19] The formula can also be used by selecting the rate of substitution and the 1 percent level.

generally have little effect in a TELRIC proceeding, where the incumbent is assumed to be deploying an entirely new network comprised of the least-cost, most efficient technology available. Based on TELRIC principles, if it makes sense to "substitute" a particular technology with another, the incumbent is assumed to have done so already.

28. Attachment 3 to this reply declaration provides an analysis of TFI's fiber in the feeder estimates. Page 1 of this analysis shows the percent of fiber in the feeder to working lives predicted by TFI in its 1988, 1994, 1997 and 2003 industry-wide studies.[20] In 1988, TFI predicted a substitution of 78.54 percent by 2001; in 1994 its prediction for 2001 dropped to 45.9 percent; in 1997 its prediction dropped to 34.6 percent; and in 2003 reported that the actually experienced substitution in 2001 was 32.7 percent. Page 2 portrays graphically this data and demonstrates how TFI's fiber in the feeder substitution rate estimates have lengthened as actual data became available. That data proves that TFI predications have been consistently wrong for over a decade.

29. Attachment 4 provides a similar analysis of TFI's fiber in the distribution network estimates. Page 1 of this analysis shows TFI's predictions of the percent of fiber in the distribution network to household lines in its 1994, 1997 and 2003 industry-

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[20] Technology Substitution in Transmission Facilities for Local Telecommunications, Lawrence K. Vanston and Ralph C. Lenz (1988), Exhibit 4.10; Transforming the Local Exchange Network: Analyses and Forecasts and Technology Change, Lawrence K. Vanston (1994) ("1994 TFI Study"), Exhibit 3.9; Transforming the Local Exchange Network: Analyses and Forecasts and Technology Change, 2nd Edition, Lawrence K. Vanston, Ray L. Hodges, and Adrian J. Poitras (1997) ("1997 TFI Study"), Exhibit 3.9; Transforming the Local Exchange Network: Review & Update 2003, Lawrence K. Vanston, Ray L. Hodges (2003) ("2003 TFI Study"), Table 7.1.

wide studies.[21] In 1994, TFI predicted there would be a substitution of 42.4 percent by 2003; in 1997 its prediction for 2003 dropped to 16.8 percent, and its latest prediction for 2003 is now .5 percent. Page 2 portrays graphically this data, and again demonstrates the lengthening of TFI's substitution rate estimates over time as actual data have disproven TFI's earlier predictions. Of course, any commission order adopting TFI's predications would have produced depreciation lives much too short, thereby improperly inflating TELRIC costs and resulting rates.

30. Although TFI's forecasts have been provided to the FCC for over a decade, the FCC has consistently declined to rely on those forecasts in selecting plant projection lives. The FCC has stated:

> Given the significant uncertainty that even TFI acknowledges exists in forecasting plant replacement over the next fifteen years, we do not find that the carriers that advocate adoption of TFI's much shorter projection lives have met their burden. Depreciation reserves are at 52 percent, an all-time high, and have increased for each of the past five years. There is no evidence that the large wave of plant replacements forecast by TFI, which should result in increased retirements, has begun or is about to begin.
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> * * *
>
> We conclude, therefore, that the TFI study fails to establish convincingly that current projection lives are inadequate.[22]

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[21] 1994 TFI Study, Exhibit 3.15; 1997 TFI Study, Exhibit 3.37; 2003 TFI Study, Table 7.4.

[22] FCC, *1998 Biennial Regulatory Review* ,supra, at 16 (footnotes deleted).

In sum, while TFI's discussions concerning the future of technology may be interesting to some, the lives it has recommended have been highly inaccurate and consistently too short. As a result, TFI's recommendations do not provide an appropriate benchmark for lives to be used in TELRIC calculations.

31. Most recently, in the *Virginia Arbitration Order*, the FCC Wireline Competition Bureau rejected Verizon's use of financial reporting lives and supporting TFI studies, finding them too heavily reliant on unrealistic assumptions regarding massive retirement of copper. Echoing my own concerns, the Bureau concluded as follows:

> Verizon's argument that the TFI study validates its proposal is also unconvincing. As AT&T/WorldCom explain, the TFI study assumes that new technology will result in massive waves of retirements (e.g., replacements of copper cable by fiber-to-the home facilities). Although TELRIC assumes that the value of an incumbent network is constrained by the widespread deployment of the most efficient technology currently available, that does not mean that it is appropriate to assume massive retirements of copper facilities. Our finding here is entirely consistent with the [FCC's] most recent analysis of the TFI analyses.[23]

When faced with the same evidence – and the same TFI studies -- provided to us here, the Bureau further concluded that: "AT&T/WorldCom convincingly demonstrate that past TFI studies have been extremely aggressive in their projections, and that actual ILEC retirements have proceeded at a much slower

[23] Virginia Arbitration Order, at 118.

pace." [24] This recent decision only confirms my conclusion that the TFI lives are much to short to be used as a benchmark in UNE proceedings.

IV. BELLSOUTH'S PORTRAYAL OF SWITCHING TECHNOLOGY LIVES IS MISLEADING

32. BellSouth contends that "the history of changes in switching technology illustrates accelerating rates of technological obsolescence."[25] BellSouth states that there were 45 years between the time the first step-by-step switch was introduced and the first crossbar switch; 27 years, between the first crossbar switch and the first analog stored program control ("SPC") switch; and only 12 years between the first analog SPC switch and the first digital SPC switch. BellSouth states that "these displacement scenarios support the prediction that digital switches installed today will have shorter lives than those installed in the past."[26] BellSouth's data is shown on Page 1 of Attachment 5, and portrayed graphically on Page 2.

33. BellSouth's selective portrayal of switching technology lives is misleading, to say the least. The consideration of data apparently omitted by BellSouth concerning the particular technologies that pre-dated (i.e., cordboard) and post-dated (i.e., digital SPC) the three switch technologies that BellSouth chose to present paint a rather different picture. Consideration of these two additional technologies on

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[24] *Id.*

[25] Comments of BellSouth, at 36.

[26] Id.

Page 1 of my Attachment 5, and its portrayal graphically on Page 3, reveal no discernable trend in the lives of switching technologies. One is led, therefore, to a conclusion quite different from that reached by BellSouth. The modularity and flexibility inherent in digital SPC switches has already allowed them to remain the technology of choice for as long as crossbar switches (27 years), and their future remains bright. As I showed in my Declaration, the latest life indications for BOC digital switching investment have stabilized at about 17 years.[27]

34. Of greater importance, of course, is the fact that existing technologies remain economically productive for many years after the introduction of a successor technology. BellSouth notes, for example, that about 5 percent of its access lines are still served by analog switches, a full 27 years after the initial introduction of digital switches.[28] The lives developed using substitution analysis by BellSouth are as flawed as those developed by TFI and discussed above. BellSouth's simplistic portrayal of switching technology lives is misleading, and fails to support lives shorter than those prescribed by the FCC.

V. OTHER COMPANY LIVES DO NOT PROVIDE AN APPROPRIATE BENCHMARK

35. Dr. Lacey states that Verizon also benchmarks its GAAP lives reported by its competitors in their annual reports.[29] Verizon's recent discovery responses in a

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[27] Lee Declaration, Attachment 6, at 3-4.

[28] BellSouth Comments, at 35. In contrast to this actual BellSouth experience, TFI predicts in it's latest study that the 5 percent survival level for digital switches will be reached in 2012, only 8 years from now (2003 TFI Study, Table 5.4).

[29] Lacey Declaration, at 22.

recent state UNE pricing case, however, reveal that these "benchmark" companies are not other local exchange carriers, but "AT&T, MCI and CATV companies."[30] The Commission has specifically found that "the depreciation practices of IXCs and incumbent LECs are not directly comparable because they use different types of switches and cables."[31] The same is also true of the depreciation practices of cable TV operators. In any event, the financial book lives of these and other competing carriers are all based on GAAP, and subject to the conservatism principle I described at length above. All that these comparisons serve to prove is that the financial book lives used by Verizon are similar to the financial book lives used by other companies. Such lives may protect the interests of investors, but they are not appropriate for use in TELRIC calculations.

VI. DR. LACEY'S CRITICISMS OF FCC LIVES ARE BASELESS

36. As I explained in my Declaration, depreciation under TELRIC should be based on the FCC's prescribed lives.[32] Such lives are forward-looking, which is empirically confirmed by the fact that the ILECs' depreciation reserve levels have been steadily increasing.[33] Dr. Lacey claims that the FCC's lives are not forward-

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[30] Docket No. TO00060356, *In the Matter of the Board's Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.*, New Jersey BPU Docket No. TO00060356, Verizon NJ response to AT&T data request AT&T-31 (served Jan. 16, 2004).

[31] *1998 Biennial Regulatory Review* ,supra, at 18 (footnotes deleted).

[32] Lee Declaration at 11-45.

[33] Id., at 15-21.

looking (because they allegedly do not account for the current and expected rate of innovation and level of competition in the local telephone industry) and that depreciation reserves could be increasing for other reasons.[34] Dr. Lacey's claims are incorrect and have been repeatedly rejected by the FCC and state commissions.

37. The FCC's projection lives are unquestionably forward-looking. The FCC explicitly considers the potential for facilities-based entry, bypass and technological change. FCC prescribed lives reflect a rigorous application of forward-looking principles, including a "detailed analysis of each carrier's most recent retirement patterns, the carriers' plans, and the current technological developments and trends."[35] As the Commission has repeatedly ruled, the ILECs must produce evidence that the existing FCC-prescribed lives are in fact longer than warranted by the expected economic lives of the assets, and none of the ILECs has offered any concrete evidence that competitive trends have shortened its asset lives since the FCC's lives were established. The FCC's lives have survived thorough scrutiny by the FCC since 1996, and have been accepted by numerous state commissions in recent years. Indeed, when it reviewed the prescribed life ranges in 1999, the FCC reaffirmed that its lives: (1) "represent the best forward-looking estimates of depreciation lives" and (2) were therefore appropriate for use by state commissions "for determining the

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[34] Lacey Declaration at 35-40.

[35] *Prescription Simplification*, Third Report and Order, FCC 95-181 (rel. May 4, 1995), at 11.

appropriate depreciation factors for use in establishing high cost support and interconnection and UNE prices."[36] My Declaration quoted extensively from those state commission decisions.[37]

38. If the 1996 Act has had any effect on economic lives, it has been to create *alternatives* to facilities-based bypass—i.e., the purchase of UNEs or the resale of wholesale services—that tend to *lengthen* the economic lives of ILEC assets. Likewise, the advent of Digital Subscriber Line ("DSL") technology exemplifies the ability of innovation to lengthen the lives of existing assets.

39. In addition, the growing levels of depreciation reserves throughout the local telephone industry provide empirical confirmation that the FCC lives are forward-looking. Indeed, the FCC has consistently viewed the depreciation reserve as an extremely important indicator of the depreciation process. The growth of depreciation reserve percents since 1980 indicates that the depreciation process is resulting in adequate depreciation accruals, and that the FCC's projection life estimates have been forward-looking and unbiased. Dr. Lacey contends that the ILECs' reserves *could* be growing for other reasons – specifically, that the ILECs have been changing their mix of assets and that the age of their assets has

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[36] *See 1998 Biennial Regulatory Review ,supra,* at 14; *United States Telephone Associations Petition for Forbearance from Depreciation Regulation of Price Cap Local Exchange Carriers*, ASD 98-91, Memorandum Opinion and Order (FCC 99-397), rel. December 30, 1999, at 61. *See also Federal-State Joint Board on Universal Service*, 12 FCC Rcd. 8776 (1997) at 250 (determining that FCC would use its existing prescribed depreciation lives in calculating universal service subsidies).

[37] Lee Declaration, at 29-35

increased (relative to their projected lives) – but these contentions have been previously rejected.[38]

40. In fact, Dr. Lacey is confusing what the depreciation reserve should be (the "theoretical" reserve) with what the reserve actually is (the "book" reserve). For example, Dr. Lacey asserts that "the depreciation reserve will increase (both as the total amount of depreciation reserve and depreciation reserve as a percentage of the cost of the asset) as the average age of the assets increase," and that this is true whether or not the lives are forward-looking.[39] This statement is obviously incorrect. It is true that as the age of assets increase, the amount of depreciation reserve should increase. In other words, the "theoretical" reserve increases. But whether or not the "book" reserve increases, decreases or remains the same is totally dependent upon the depreciation accruals made each year. In turn, these depreciation accruals are primarily dependent upon the projection life selected for the account in question. Forward-looking projection lives ensure that a company's book reserves will keep pace with changes in its theoretical reserve.

41. Taking Verizon-Virginia ("VZ-VA") as an example, according to VZ-VA's annual filings made with the FCC, its composite theoretical reserve has risen by 5.9% since 1998. More importantly, VZ-VA's actual book reserve has increased by 9.6% during the same period, as the following table shows:

	THEORETICAL	BOOK

[38] Lacey Declaration, at 39-40.

[39] Id., at 40.

DATE	RESERVE	RESERVE
1/1/98	42.9%	46.0%
1/1/99	43.4%	47.4%
1/1/00	44.5%	49.4%
1/1/01	44.9%	50.8%
1/1/02	44.6%	52.6%
1/1/03	48.8%	55.6%

The projection lives prescribed by the FCC for VA-VZ have resulted in a reserve surplus (i.e. – book minus theoretical) of over $500 million as of January 1, 2003.

42. Similarly, according to annual filings made by Verizon-New Jersey ("VZ-NJ") with the FCC, its composite theoretical reserve has increased by 5.3% since 1998, and VNJ's actual book reserve has increased by 9.7% during the same period, as the following table shows:

DATE	THEORETICAL RESERVE	BOOK RESERVE
1/1/98	47.9%	48.1%
1/1/99	47.9%	49.7%
1/1/00	48.1%	50.7%
1/1/01	48.9%	52.2%
1/1/02	49.2%	54.3%
1/1/03	53.2%	57.8%

The projection lives prescribed by the FCC for VZ-NJ have resulted in a reserve surplus (i.e., book minus theoretical) of over $500 million as of January 1, 2003. The results are not different in other Verizon states.

43. Dr. Lacey also contends that "the depreciation reserve will grow if the company changes its asset mix and begins adding new assets that have a shorter life than

the older assets that are still in place and continuing to be depreciated. [40] Once again, he confuses the theoretical reserve with the book reserve. It is true that the composite theoretical reserve percent may increase as the asset mix changes (it may also stay the same or decrease). For example, assume the company has two asset accounts in Year 1 as follows:

ACCOUNT	PLANT	THEORETICAL RESERVE	PERCENT
A	1000	400	40.0%
B	1000	400	40.0%
Composite	2000	800	40.0%

Next assume that four years later the account reserves appear as follows:

ACCOUNT	PLANT	THEORETICAL RESERVE	PERCENT
A	1000	400	40.0%
B	800	400	50.0%
Composite	1800	800	44.4%

In this example, the theoretical reserve percent of Account A has remained stable, while the theoretical reserve percent of Account B has risen. In other words, the age of Account B is greater relative to its expected life. Note that, contrary to Dr. Lacey's contention, whether the expected life of Account B is greater or less that the expected life of Account A is irrelevant. What matters is the average age of the plant in each account *relative* to its expected life.

44. To some degree, the mix of plant may have contributed to the increase in *theoretical* reserve experienced by VZ-VA and VZ-NJ as discussed above. Once

[40] Id.

again, however, the increase in their *book* reserve is attributable to accruals booked each year pursuant to the FCC's forward-looking projection life prescriptions. The mix of accounts has not been a significant factor, since the book reserves of all the major accounts have increased, as shown in Attachments 6 and 7 to this testimony. The book reserve increases are dramatic, especially considering the growth that each account has experienced. VZ-VA's results (Attachment 6) are as follows:

ACCOUNT	GROWTH	BOOK RESERVE 1992	2002
Digital Switch	181%	25.1%	51.0%
Digital Circuit	160%	36.9%	63.4%
Aerial Cable	55%	40.8%	63.9%
Underground Cable	31%	27.4%	57.3%
Buried Cable	68%	38.4%	58.7%

And VZ-NJ's results (Attachment 7) are as follows:

ACCOUNT	GROWTH	BOOK RESERVE 1992	2002
Digital Switch	48%	28.0%	46.1%
Digital Circuit	163%	42.2%	63.3%
Aerial Cable	66%	38.7%	57.8%
Underground Cable	43%	40.0%	76.8%
Buried Cable	71%	30.5%	60.9%

Since the reserves of all major accounts have been increasing, the mix of accounts has not been a significant factor.

VERIFICATION

I, Richard B. Lee, declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information and belief. Executed on January 30, 2004.

/s/ Richard B. Lee

Richard B. Lee